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Supreme Court, U.S.
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No. 97-603

IN THE
Supreme Court of the United States
OCTOBER TERM, 1997

BOWATER INCORPORATED AND SUBSIDIARIES,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF OF *AMICUS CURIAE* NATIONAL FOREIGN TRADE COUNCIL, INC. IN SUPPORT OF PETITIONER'S REQUEST FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the interest expense to be allocated and apportioned, pursuant to Treasury Regulation § 1.861-8(e), is net interest expense (that is, gross interest expense minus offsetting interest income).

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STATEMENT OF INTEREST

The National Foreign Trade Council, Inc. ("NFTC") is a New York not-for-profit corporation with more than 550 member firms concerned with international trade and investment.[1] Interests of NFTC members account for over seventy percent of all United States exports and direct private investment abroad.

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[1] Counsel for amicus curiae and others, other than counsel for a party, authored this brief. No other person or entity other than amicus curiae and its members made monetary contributions for the preparation and submission of the brief.

The NFTC has a strong interest in the Court's resolution of this case because the Second Circuit Court of Appeals in this case, and the Fifth Circuit Court of Appeals in *Dresser Industries, Inc. v. Commissioner*, 911 F.2d 1128 (5th Cir. 1990), are in direct conflict on the issue of whether, pursuant to Treas. Reg. § 861, interest expense is to be allocated after having first been reduced by interest income (thus, allocating net interest expense). The Court's answer to this question will impact all of NFTC's member companies.

Counsel for the parties have consented to the filing of this brief in letters filed with the Clerk of the Court.

STATEMENT OF THE CASE AND FACTS

Amicus adopts the statement of the case and facts as set forth by Petitioner.

REASONS FOR GRANTING THE PETITION

The Second Circuit's decision in this case, hereafter also referred to as *Bowater* and reported at 108 F.3d 12 (1997), directly conflicts with the Fifth Circuit's decision in *Dresser Industries, Inc. v. Commissioner,* 911 F.2d 1128 (5th Cir. 1990), on the issue of allocation of interest expense under Treas. Reg. § 1.861-8 (the "§ 861 Regulations"), when determining certain foreign source income of a Domestic International Sales Corporation ("DISC"). The Second Circuit held that the § 861 Regulations require the allocation of gross interest expense, whereas the Fifth Circuit held that interest income first reduces interest expense, resulting in an allocation of net interest expense.

The § 861 Regulations are used extensively in the foreign tax area to calculate limitations under a wide variety of Internal Revenue Code sections. The interpretation of these

regulations should be uniform so that all United States based multinational companies are on an even playing field.

In *Dresser,* the Fifth Circuit noted that the § 861 Regulations set out the *method* of allocating interest expense, but not the *amount* of interest expense that must be allocated.[2] *Dresser,* 911 F.2d at 1135. The concept that money is fungible underlies the regulation. Applying the fungibility concept, the Fifth Circuit determined that the interest to be allocated should represent the "actual cost of financing," which is best represented by *net* interest expense.

In *Bowater,* however, the Second Circuit reasoned that if interest expense is to be allocated to all income producing activities, then it should be allocated against interest income on the same basis as it is allocated to other types of income, and not first be specifically allocated to interest income.

The issue of netting interest income against interest expense was first addressed in *General Portland Cement Co. v. U.S.*, 628 F.2d 321 (5th Cir. 1980), *cert. denied*, 450 U.S. 983 (1981), and again a few years later in *Ideal Basic*

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[2] Dresser involved the pre-1977 regulations, which differ slightly from the version of the Regulations at issue in *Bowater.* However, the *Dresser* and *Bowater* holdings differ based on the court's interpretation of the underlying purpose of the regulations, and not because of any slight wording changes in the regulations. The regulations under *Dresser* read as follows:

> From the items of gross income specified in §§ 1.861-2 to 1.361-7, inclusive, as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income.

Treas. Reg. § 1.861-8(a) (as amended in 1975).

Industries, Inc. v. Commissioner, 82 T.C. 352 (1984). Those cases involved the calculation of a depletion allowance which was limited to 50% of taxable income from a producing property. A portion of the corporation's interest expense had to be allocated against extraction income to determine the 50% limitation.

In *General Portland*, the Fifth Circuit determined that the purpose behind the 50% limitation was best served "by subtracting the *actual* cost of interest, rather than an inflated amount. Taxpayer's actual cost of interest is its 'net' interest expense." *General Portland Cement*, 628 F.2d at 344; quoted in *Ideal Basic*, 82 T.C. at 402. The Internal Revenue Service acquiesced in both decisions, acknowledging that "the effective amount of interest available to a taxpayer as a deduction for income tax purposes is the net cost of borrowing the money and not the higher book amount which fails to take into account the fact that the borrowed money has been reinvested." *See* IRS Action on Decisions 1986-022 and 1986-023 (Feb 26, 1986).

The logic of *General Portland* and *Ideal Basic* was cited with approval in *Dresser*, 911 F.2d at 1134, with regard to the § 861 Regulations. The Fifth Circuit noted that the objective of both the depletion provisions and the § 861 Regulations was to apportion among related business operations the "actual cost of borrowing," which requires allocating the net interest expense. *Dresser,* 911 F.2d at 1135-1136. The *Dresser* decision was followed by the Tax Court opinion in this case, 101 T.C. 207, 212, 214 (1993), *The Coca-Cola Company v. Commissioner,* 106 T.C. 1,4,31 (1996), and *Computervision Int'l Corp. v. Commissioner*, 71 T.C.M.(CCH) 2450, 2465 (1996).

Therefore, the Second Circuit's *Bowater* decision, which disallows interest netting, is in direct conflict with this line of cases.

The § 861 Regulations are pervasive in the foreign tax arena, and are used when calculating various types of foreign income, losses or limitations, and not just for the combined taxable income of a DISC and related party. While it is true that, in September 1988, Treasury issued new, temporary regulations relating to the allocation and apportionment of various expenses that appear on their face to be at odds with the pre-1988 regulations (*see* Treas. Reg. § 1.861-9T(a), 53 Fed. Reg. 35647 (1988), the NFTC agrees with the Second Circuit's conclusion (and the Respondent's corresponding analysis of the temporary regulations in that forum, Brief of the United States at 11) "that the temporary regulation merely reiterates, or clarifies, the Regulation at issue here" and does not change the rules for apportionment of interest expense. *See* 108 F.3d at 17. Rather, these regulations confirm the validity of the fungibility concept of money that was first specifically espoused in the post-1977 regulations. Thus, the NFTC believes the question presented in this case has continuing significance.

Virtually every company doing business internationally must calculate foreign source income under Treas. Reg. § 1.863-1(c), the overall limitation on the foreign tax credit under Treas. Reg. § 1.904-1(b)(1), and various foreign tax credit basket limitations under Treas. Reg. § 1.904-4(c)(2), all of which cross-reference to the § 861 Regulations. The foreign tax credit can also be affected by the "look-through" rules, which implicate the § 861 Regulations. Treas. Reg. § 1.904-5(c)(2)(ii). If a taxpayer is an oil company, it must use the § 861 Regulations to determine whether interest received from a foreign corporation is foreign oil related income under

Treas. Reg. § 1.907(c)-2(d)(2). If a taxpayer had net foreign losses, it must use the § 861 Regulations to calculate its overall foreign loss limitations under Treas. Reg. § 1.904(f)-1(c)(3). Controlled foreign corporations must use the § 861 Regulations to determine foreign base company income for subpart F purposes. Treas. Reg. § 1.954-1(c)(i).

Therefore, the issue of how to calculate the above-listed limitations, and whether foreign source income should be reduced by an allocation of gross or net interest expense, is of great importance to every U.S. company that does business overseas. Among other things, the § 861 Regulations determine how much of their foreign taxes are creditable, and can directly impact their competitiveness in the world market.

Further, multinational corporations should not have to face different results in the interpretation of the § 861 Regulations depending upon where they reside. A taxpayer located in the Second Circuit may not net interest income against interest expense. A taxpayer in any other circuit would have substantial authority to "net". Thus, the Court's review of this case would serve judicial economy by avoiding further litigation of this issue.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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